

Hearing on the state of implementation and prospects of fiscal federalism

Summary

29 May 2024 | The Parliamentary Budget Office (PBO), represented by the Board member Giampaolo Arachi, today held a hearing at the Parliamentary Committee for the Implementation of Fiscal Federalism. Two years after the previous hearing, in his report the Board member focused on the main changes that have affected regional federalism, the financial autonomy of local authorities, municipal equalisation, and the determination and financing of the Essential Service Levels (ESLs). He furthermore outlined the main critical issues that still exist in these areas, also in light of the application of the new European budgetary rules and the implementation of differentiated autonomy.

The implementation of fiscal federalism has experienced a relative acceleration in recent years but has mainly concerned local authorities. In the three-year period 2020-22, a gradual overcoming of the historical criterion in the distribution of equalisation transfers has been envisaged for Municipalities, and a reinforcement process has been initiated for the functions of kindergartens, social services and transport of students with disabilities through the allocation of additional resources and the setting of service objectives. For Provinces and Metropolitan cities, additional resources have been allocated, based on an estimate of the standard expenditure needs for fundamental functions, and two separate equalisation funds have been established to distribute the contribution to public finance on the basis of expenditure needs and fiscal capacity.

In the last two years, measures have been taken to strengthen municipal services and, following ruling No. 71/2023 of the Constitutional Court, the financing and monitoring methods have been modified, and changes have been made to the sanctioning system in the case of non-compliance by Authorities in the allocation of resources.

At present, several critical issues still remain.

Progresses are still limited in overcoming the application of the historical criterion (allocation of resources based on the expenses incurred in the past) in areas other than healthcare under the competence of ordinary statute Regions (OSRs). The finalisation of regional federalism is now the subject of a specific milestone (M1C1-119) of the National Recovery and Resilience Plan (NRRP) to be achieved by the first quarter of 2026 as part of the enabling Reform of the Subnational Fiscal Framework (M1C1 – Reform 1.14). In order to achieve the target, it is necessary to timely complete the key steps concerning the identification of the State government transfers to be replaced with taxes and the specific taxes to be used, and the determination of the ESLs related to regional matters.

The replacement of State transfers to the Regions with taxes requires, however, a more general reorientation of the role played by the central administrations. These will no

longer be able to impose allocation constraints on equalisation transfers but instead will have to safeguard the territorial homogeneity of the provision of services related to civil and social rights through the determination and monitoring of the ESLs and the activation of the State's substitutive powers provided for by article 120 of the Constitution in the event of non-compliance.

There is a clear need to strengthen the financial autonomy of local authorities and this need must be addressed by the implementing decrees of the enabling law on tax reform. Municipalities, Provinces, and Metropolitan Cities have almost exhausted the available fiscal space. A contribution to this was given, on the one hand, by the cuts in State transfers made over the past decade for the consolidation of public finance and, on the other hand, by the reduction in the tax base caused by the reforms on real estate taxation and on Irpef (Personal Income Tax) for Municipalities and by the evolution of the car fleet for Provinces and Metropolitan Cities. In addition, there is a difficulty in collecting taxes that is particularly evident at the municipal level. It is desirable that the implementing decrees of the enabling law on tax reform address measures to strengthen the collection capacity of own taxes, to identify new funding sources for the Provinces and Metropolitan Cities, and to rationalise and broaden the tax bases on which municipal finance is based.

The full implementation of equalisation based on standard expenditure needs and tax capacities has to be ensured at the municipal level, which is currently hindered by the presence of correctives to mitigate negative variations in the Municipal Solidarity Fund (MSF) and by significant financial flows distributed outside of it on the basis of historical criteria. The sterilisation of losses produced by the advancement of the equalisation mechanism appears to be financially unsustainable and, as noted by the Constitutional Court, in contradiction with the very objective of the reform of fiscal federalism. Several simulation exercises show that the inclusion in equalisation of the components of the MSF so far excluded, in besides ensuring a greater correspondence between resources and needs and greater transparency, could reduce the number of Municipalities, especially small ones, that risk suffering a reduction in resources as equalisation progresses. Any municipal peculiarities reflected in the historical allocation should be more accurately captured through the updating of standard expenditure needs and fiscal capacities.

It would be desirable for the distribution of contributions to public finance for local authorities as a whole to be carried out using the equalisation funds as well, both to ensure their consistency with the financing needs of fundamental functions and to avoid introducing an additional flow into the MSF that is unrelated to the equalisation purpose of the fund.

The framework of the ESLs, which should serve as a reference for determining needs and allocating the equalisation funds, remains fragmented. Since 2021, several measures have introduced paths towards the ESLs with different financing and monitoring modalities. This has led to the need for greater coordination between different levels of

government and a clear definition of responsibilities in order to be able to intervene with forms of receivership in cases of non-compliance.

It is desirable that the determination of ESLs for matters for which the OSRs are responsible does not become secondary to actions necessary for the implementation of differentiated autonomy. The draft law currently under examination by the Chamber of Deputies outlines a fast track for the determination of ESLs in matters on which the Regions may request increased autonomy.

The completion of fiscal federalism could be facilitated by the application of the new European budgetary rules that envisage the growth rate of net primary expenditure as the only indicator for monitoring public accounts. The indication of a policy path for net primary expenditure by sector, consistent with the maximum limit agreed with the European Council for the General Government, will necessarily have to take into account the different weight of the non-compressible components of expenditure, such as those for fundamental functions and ESLs, and those related to the commitments undertaken in the structural budget plan with regard to investments. Once the path of net primary expenditure has been set, it will be necessary to ensure a consistent evolution of local authorities' revenues, net of the discretionary measures implemented by the latter, through the periodic revision of transfers and revenue-sharing. Expenditure planning could be the moment to assess the adequacy of resources and their future evolution, facilitating the management of budgets and the operation of equalisation mechanisms.

The management of the Regions that request greater autonomy (*Regioni ad autonomia differenziata, RAD*) revenue-sharing entrusted to bilateral negotiations within the Joint Committees could jeopardise the growth targets of net expenditure with consequent adjustments that could fall on other Regions and/or on other sectors of the General Government. Therefore, the need remains to provide for a single institutional body where evaluations and decisions can be made in a coordinated manner and with an overall assessment that also involves the determination of the revenue-sharing that, according to Legislative Decree 68/2011, should finance the regional equalisation fund under symmetric federalism.